

# Inspector General

## United States

## Department of Defense



Navy Reporting of Financing  
Payments for Shipbuilding  
on the Financial Statements

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## **Acronyms and Abbreviations**

BEIS	Business Enterprise Information System
CAMS-ME	Capital Asset Management System-Military Equipment
CHOOSE	Cash History On-line Operator Search Engine
CIP	Construction-in-Progress
DDRS	Defense Departmental Reporting System
FAC	Financial Accounting Code
FMR	Financial Management Regulation
IG	Inspector General
NAVSEA	Naval Sea Systems Command
OUSD(C)/DoD CFO	Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer
P&EPO	Property and Equipment Policy Office
PP&E	Property, Plant, and Equipment
SFFAS	Statement of Federal Financial Accounting Standards
STARS	Standard Accounting and Reporting System



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

March 26, 2009

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/DOD CHIEF FINANCIAL OFFICER

DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS FOR PROPERTY AND EQUIPMENT POLICY  
DIRECTOR, OFFICE OF FINANCIAL OPERATIONS, ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)  
DIRECTOR, ACQUISITION RESOURCES & ANALYSIS FOR PROPERTY & EQUIPMENT POLICY  
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE  
NAVAL INSPECTOR GENERAL

SUBJECT: Navy Reporting of Financing Payments for Shipbuilding on the Financial Statements (Report No. D-2009-065)

We are providing this final report for review and comment. The Acting Deputy Director, Acquisition Resources and Analysis for Property and Equipment Policy; and the Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) did not provide comments on the draft report; however, we considered comments from the Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Acting Deputy Chief Financial Officer's comments were not responsive. In addition, the Acting Deputy Director, Acquisition Resources and Analysis for Property and Equipment Policy; and the Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) did not provide comments on the draft report. Therefore, we request additional comments by April 27, 2009.

Please provide comments that conform to the requirements of DoD Directive 7650.3. If possible, send your comments in electronic format (Adobe Acrobat file only) to [AUDCOLU@dodig.mil](mailto:AUDCOLU@dodig.mil). Copies of management comments must have the actual signature of the authorizing official for your organization. We are unable to accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, you must send them over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5868, DSN (664-5868).

*Patricia A. Marsh*  
Patricia A. Marsh  
Assistant Inspector General  
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# Results in Brief: Navy Reporting of Financing Payments for Shipbuilding on the Financial Statements

## What We Did

We determined whether the Defense Finance and Accounting Service and the Department of the Navy properly reported contract financing payments for shipbuilding contracts on the DoD and Navy financial statements. In addition, we determined whether the Property and Equipment Policy Office (P&EPO) and the Navy could improve the process to capture shipbuilding Construction-in-Progress (CIP) balances.

## What We Found

- For the eight classes of ships, the Navy improperly recorded approximately \$29 billion of shipbuilding payments as expenses instead of CIP on the March 31, 2008, financial statements (finding A).
- Revised guidance from the Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer conflicts with Federal accounting standards, and there is a high probability that the Navy will continue to misclassify shipbuilding contract financing payments (finding A).
- The P&EPO and Navy accounting and valuation methodology resulted in an incomplete and inaccurate list of ships under construction and inaccurate valuation of those ships (finding B).
- The P&EPO and Navy internal controls were not adequate. We identified material internal control weaknesses in entering data into the Capital Asset Management System—Military Equipment and ensuring that the P&EPO CIP balance is accurate.

## What We Recommend

We recommend that:

- the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer revise guidance so that it complies with Federal accounting standards and does not create duplicate postings of shipbuilding contract financing payments and

- the Acting Deputy Director, Acquisition Resources and Analysis for Property and Equipment Policy; in conjunction with the Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller); implement controls that will ensure that there is a complete and accurate shipbuilding CIP balance.

## Management Comments and Our Response

The Acting Deputy, Chief Financial Office disagreed with the recommendations. The Acting Deputy stated that contract financing payments are intangible assets and Federal accounting standards require the payments to be recorded as Advances. The Deputy's comments were nonresponsive because Federal standards require that the assets funded by contract financing payments be recorded in the CIP account. We did not receive comments from the Acting Deputy Director, Acquisition Resources and Analysis for Property and Equipment Policy or the Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller). We request the current and newly appointed management provide comments in response to this final report. Please see the recommendations table on the back of this page.



**USS Ronald Reagan (CVN 76)**

## Recommendations Table

Management	Recommendations Requiring Comment	No Additional Comments Required
Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer	A.1.a., A.1.b., A.1.c.	
Acting Deputy Director, Acquisition Resources and Analysis for Property and Equipment Policy	B.1., B.2., B.3.	
Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller)	A.2., B.1., B.2., B.3.	

**Please provide comments by April 27, 2009.**

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# Introduction

## Objectives

We determined whether the Defense Finance and Accounting Service and the Navy properly reported contract financing payments for shipbuilding contracts on the DoD and Navy financial statements. In addition, we determined whether the Property and Equipment Office (P&EPO) and the Navy could improve the process to capture shipbuilding Construction-in-Progress (CIP) balances. See the Appendix for a discussion of the scope and methodology and for prior coverage.

## Background

The Naval Sea Systems Command (NAVSEA) is responsible for engineering, building, buying, and maintaining ships, submarines, and combat systems to meet the Navy's current and future operational requirements. The Navy pays for construction of ships, submarines, and combat systems primarily through the use of contract financing payments. Contract financing payments are payments made to contractors prior to acceptance of supplies or services.

### ***Navy Shipbuilding Contract Financing Payments***

The Navy uses three types of payments for shipbuilding: progress, performance-based, and interim payments on cost-reimbursement contracts. Progress payments are contract financing payments based on the contractor costs or percentage of completion. Performance-based payments are based on objective, quantifiable methods; such as accomplishing defined goals. The Navy should issue interim payments on cost-reimbursement contracts when uncertainties involved in the price of the contract do not permit the cost of the contract to be accurately estimated.

As of March 31, 2008, the Navy was constructing 31 ships in 8 different classes of ships. See Table 1 for specific ships.

**Table 1. Ships Under Construction**

Class	Name	Number	Type of Financing
CVN 68	George H. W. Bush	CVN 77	Progress Payment for cost and performance
CVN 68	Gerald R. Ford	CVN 78	Interim Payments for Cost Contract
DDG 51	Truxtun	DDG 103	Progress Payment for cost and performance
DDG 51	Dewey	DDG 105	Progress Payment for cost and performance
DDG 51	Stockdale	DDG 106	Progress Payment for cost and performance
DDG 51	Gravely	DDG 107	Progress Payment for cost and performance
DDG 51	Wayne E. Meyer	DDG 108	Progress Payment for cost and performance
DDG 51	Jason Dunham	DDG 109	Progress Payment for cost and performance
DDG 51	William P. Lawrence	DDG 110	Progress Payment for cost and performance
DDG 51	Spruance	DDG 111	Progress Payment for cost and performance
DDG 51	Unnamed*	DDG 112	Progress Payment for cost and performance
SSN 774	New Hampshire	SSN 778	Progress Payment for cost and performance
SSN 774	New Mexico	SSN 779	Progress Payment for cost and performance
SSN 774	Missouri	SSN 780	Progress Payment for cost and performance
SSN 774	California	SSN 781	Progress Payment for cost and performance
SSN 774	Mississippi	SSN 782	Progress Payment for cost and performance
SSN 774	Unnamed*	SSN 783	Progress Payment for cost and performance
LHD 1	Makin Island	LHD 8	Progress Payment for cost and performance
LPD 17	Green Bay	LPD 20	Progress Payment for cost and performance
LPD 17	New York	LPD 21	Interim Payments for Cost Contract
LPD 17	San Diego	LPD 22	Progress Payment for cost and performance
LPD 17	Anchorage	LPD 23	Progress Payment for cost and performance
LPD 17	Arlington	LPD 24	Progress Payment for cost and performance
LPD 17	Somerset	LPD 25	Progress Payment for cost and performance
AKE 1	Robert E. Peary	AKE 5	Progress Payment for cost and performance
AKE 1	Amelia Earhart	AKE 6	Progress Payment for cost and performance
AKE 1	Carl Brashear	AKE 7	Progress Payment for cost and performance
AKE 1	Wally Schirra	AKE 8	Progress Payment for cost and performance
LCS 1	Freedom	LCS 1	Interim Payments for Cost Contract
LCS 1	Independence	LCS 2	Interim Payments for Cost Contract
T-AGM	Unnamed*	T-AGM 25	Performance Based Payments

\* At the time of the audit, these ships had not been assigned a name

### **Navy Balance Sheet Scope**

The Navy reported \$187 billion in General Property, Plant, and Equipment (PP&E) on the March 31, 2008, General Fund financial statements, which included \$169 billion in Military Equipment and \$3.1 billion in CIP.

The Navy also reported \$7.6 billion in Total Other Assets on the March 31, 2008, General Fund financial statements, which included \$6.9 billion in outstanding contract financing payments.

## ***Property and Equipment Policy Office***

The P&EPO is a Component of the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics. The P&EPO is responsible for developing solutions to allow DoD Components to comply with Federal financial accounting standards as they relate to military equipment, as well as resolving existing accounting and reporting problems for military and general purpose equipment.

The P&EPO compiles and maintains a spreadsheet of the Navy shipbuilding CIP balance. Statement of Federal Financial Accounting Standards (SFFAS) No. 6, “Accounting for Property, Plant and Equipment,” uses the term “construction work in process” but the United States Standard General Ledger uses the CIP.” We will use CIP to be consistent with the DoD presentation.

## **Review of Internal Controls**

We identified material internal control weaknesses at the P&EPO and the Navy as defined by DoD Instruction 5010.40, “Managers’ Internal Control (MIC) Program Procedures,” January 4, 2006. The P&EPO and Navy did not have adequate controls in place for entering data into the Capital Asset Management System-Military Equipment (CAMS-ME) and ensuring that the P&EPO CIP balance is accurate. There was no guidance or training on how or when to update CAMS-ME.

Implementing Recommendations B.1., B.2., and B.3. will improve the P&EPO and Navy internal control procedures and result in improved reporting of the shipbuilding CIP ending balance. We will provide a copy of this report to the senior official responsible for internal controls at P&EPO and Navy.



# **Finding A. Navy Presentation of Shipbuilding Construction Contract Financing Payments on the Financial Statements**

The Navy improperly classified shipbuilding contract financing payments as expenses rather than Construction-in-Progress (CIP) on its March 31, 2008, financial statements. The misclassification occurred because the Navy followed guidance published in DoD Regulation 7000.14-R, “DoD Financial Management Regulation,” that did not provide accurate policy for recording the assets that contractors constructed. The Navy misstatement of potentially \$29 billion of shipbuilding financing payments was material to the Balance Sheet. As a result, the Navy understated the CIP account by potentially \$29 billion and overstated previously reported expenses on the Statement of Net Cost by the same amount. To improve the quality and reliability of the Navy’s reported shipbuilding costs for use by decision makers, the Office of the Under Secretary of Defense (DoD Comptroller)/DoD Chief Financial Officer (OUSD[C]/DoD CFO) needs to revise the DoD 7000.14-R to comply with Federal accounting standards.

## **Navy Presentation of Shipbuilding Contract Financing Payments**

The Navy did not present shipbuilding contract financing payments in accordance with Federal accounting standards. Specifically, in its March 31, 2008, financial statements, the Navy improperly reported shipbuilding contract financing payments as expenses on the Statement of Net Cost instead of properly reporting the payments as CIP on the Property, Plant, and Equipment (PP&E) line item on the Balance Sheet.

The Statement of Federal Financial Accounting Standards (SFFAS) No. 6, “Accounting for Property, Plant and Equipment,” June 1996 states that for constructed PP&E, the PP&E must be recorded as CIP until it is placed in service, then the balance must be transferred to the General PP&E account. SFFAS No. 6 states that PP&E shall be recognized when title passes to the acquiring entity or when the PP&E is delivered to the entity or to an agent of the entity. Title of ships under construction as well as vessel materials delivered to the contractor vest in the Navy.

To comply with Government accounting standards, the Navy must present the contract financing payments for ship construction as PP&E CIP. However, the Navy reported the majority of the shipbuilding payments as an expense in the accounting period in which it made the payment.

## **The Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer Guidance**

The Navy improperly presented shipbuilding construction contract financing payments on the March 31, 2008, financial statements because the OUSD(C)/DoD CFO issued guidance related to the presentation of contracting financing payments that conflicted with SFFAS No. 6. Specifically, DoD 7000.14-R volume 4, chapter 6, “Property, Plant and Equipment,” July 2006; its June 2008 revision; and volume 6b, chapter 4, “Balance Sheet,” January 2006, contained presentation instructions that conflicted with SFFAS

No. 6. Further, if the Navy follows the OUSD(C)/DoD CFO revision to DoD 7000.14-R volume 4, chapter 5, "Advances and Prepayments," October 2008, the Navy will continue to present shipbuilding construction contract financing payments in a way that is not compliant with SFFAS.

### ***DoD 7000.14-R Guidance Applicable to March 2008 Reporting***

DoD 7000.14-R contained guidance on real property reporting that conflicted with SFFAS No. 6. Prior to June 2008, DoD 7000.14-R volume 4, chapter 6 stated that real property should be reported in the CIP account. The guidance did not mention anything else that could be reported in the CIP account. However, SFFAS No. 6 specifically states that *entities should record constructed PP&E in the CIP account*. It does not state that entities should record only *real property* PP&E in the CIP account. Because the Navy followed the July 2006 DoD 7000.14-R guidance, the Navy did not report shipbuilding construction contract financing payments in the Navy CIP account on its March 31, 2008, Balance Sheet. Because OUSD(C)/DoD CFO changed this guidance during the course of the audit, we are not making specific recommendations to address the conflict with the SFFAS.

Additionally, the DoD 7000.14-R contained conflicting guidance as to which account the Navy could use to report the shipbuilding contract financing payments on the Balance Sheet. DoD 7000.14-R volume 6b, chapter 4 states that contract financing payments made to contractors under fixed-price contracts should be reported as Other Assets. However, volume 6b, chapter 4 specifically excludes progress payments based on a percentage of completion from the Other Asset account and requires that those payments to be reported as CIP.

DoD 7000.14-R volume 6b, chapter 4 prohibits the Navy from reporting the shipbuilding contract financing payments in the only other Balance Sheet account that could be applicable: Other Assets. Specifically, the majority of Navy shipbuilding contract financing payments are made either on cost reimbursement contracts or progress payments based on a percentage of completion or cost. The OUSD(C)/DoD CFO specifically excludes those types of contract financing methods from its guidance for the Other Asset line item and the CIP line item. The OUSD(C)/DoD CFO needs to revise this section to include cost reimbursement contracts and progress payments based on a percentage of completion or cost.

### ***Revised DoD 7000.14-R Guidance***

The revised DoD 7000.14-R guidance related to shipbuilding construction payments issued by the OUSD(C)/DoD CFO during the course of the audit still conflicts with Federal accounting standards and other DoD guidance.

Specifically, if the Navy follows the new DoD 7000.14-R volume 4, chapters 5 and 6 guidance, it will result in the Navy double posting shipbuilding contract financing payments. In addition, the new DoD 7000.14-R guidance improperly directs entities to report contract financing payments as advances and prepayments and to classify them as intangible assets. As previously noted, shipbuilding construction contract financing payments should be presented as PP&E CIP. Presenting these payments as advances and prepayments or intangible assets is not in accordance with SFFAS No. 6. Unless OUSD(C)/DoD CFO makes further revision to its guidance, the Navy will be unable to properly present shipbuilding contract financing payments.

## **Possible Duplicate Posting of Shipbuilding Construction Contract Financing Payments**

If the Navy follows the new DoD 7000.14-R, it will result in the Navy double posting shipbuilding contract financing payments. Specifically, DoD 7000.14-R volume 4, chapter 6 states that the CIP account is used for only real property assets and shipbuilding. It also states that entities should present contract financing payments in the advances and prepayments account until the entity receives the goods or services. DoD 7000.14-R, volume 4, chapter 5 includes the same requirement for presenting shipbuilding contract financing payments as advances and prepayments.

The new DoD 7000.14-R guidance provides two possible accounts to present the same shipbuilding contract financing payments. The Navy could report shipbuilding contract financing payments in both the CIP and the advances and prepayments accounts. The OUSD(C)/DoD CFO needs to remove the wording that requires shipbuilding contract financing payments to be recorded as advances and prepayments to avoid overstating the Balance Sheet. Then the guidance will agree with Federal accounting standards.

## **Contract Financing Payments as Advances and Prepayments**

The new DoD 7000.14-R improperly directs entities to present all contract financing payments as advances and prepayments. Specifically, DoD 7000.14-R volume 4, chapters 5 and 6 state that contract financing payments are cash disbursements made to a contractor to finance performance under the contract prior to acceptance of goods or services. Chapters 5 and 6 also state that the entities should record the cash disbursements in the advances and prepayments account until the entity receives the goods or services.

SFFAS No. 1, “Accounting for Selected Assets and Liabilities,” March 30, 1993, provides a definition of advances and examples for its use. SFFAS No. 1 states that advances are cash payments to cover a part or all of anticipated expenses or as advance payments for the cost of goods and services the entity acquires. Examples include travel advances disbursed to employees prior to business trips and cash or other assets disbursed under a contract, grant, or cooperative agreement before goods or services are provided by the contractor or grantee. SFFAS No. 1 also defines prepayments as payments made to cover certain periodic expenses before those expenses are incurred and excludes progress payments made to a contractor based on a percentage of completion of the contract from advances and prepayments.

Contract financing payments do not meet the definition of advances because the Government is providing payment for work either already performed by the contractor or for actual expenditures the contractor has made. Contract financing payments are not for *anticipated expenses* but instead fund work that is ongoing and progressing. Contract financing payments are also not prepayments because they are paid *after* expenses are incurred, not *before*.

OUSD(C)/DoD CFO needs to remove guidance that requires entities to present contract financing payments as advances and prepayments to ensure that entities are not reporting contract financing payments in conflict with Federal accounting standards.

## **Contract Financing as Intangible Assets**

The new DoD 7000.14-R inappropriately defines contract financing payments as intangible assets. DoD 7000.14-R volume 4, chapters 5 and 6 state that contract financing payments do not represent a tangible PP&E asset to the DoD Component. According to generally accepted accounting principles, there are two types of assets:

tangible and intangible. Because the new 7000.14-R states that contract financing payments are not tangible assets, it is asserting that they are intangible assets. However, contract financing payments are not intangible assets. Intangible assets are generally defined as noncurrent resources that do not have physical substance. They usually have a high degree of uncertainty concerning their future benefits. They include patents, copyrights, franchises, goodwill, trademarks, trade names, and secret processes. They are amortized as opposed to depreciated. The assets acquired through contract financing payments do not include such assets or benefits.

OUSD(C)/DoD CFO needs to remove the sections in DoD 7000.14-R volume 4, chapters 5 and 6 that state that contract financing payments are intangible assets.

### **Conclusion**

As a result of the Navy following DoD 7000.14-R policies, it incorrectly posted shipbuilding contract financing payments as expenses and misclassified potentially \$29 billion of shipbuilding construction financing payments. Specifically, the Navy CIP balance was understated by at least \$29 billion and the Statement of Net Cost was overstated from FY 1999 through March 2008.

The potential \$29 billion misclassification of assets as expenses is material to the Navy General Fund Balance Sheet. Specifically, the P&EPO and Navy exclusion of the shipbuilding contract financing payments represents 16 percent of the total Navy General PP&E account. Additionally, the \$29 billion represents 17 percent of the Navy Military Equipment balance and 774 percent of the Navy CIP balance.

DoD 7000.14-R volume 4, chapter 6 requires that the Navy report shipbuilding in the CIP account. Additionally, other sections of the DoD 7000.14-R require DoD entities to report contract financing in other accounts. Therefore, the OUSD(C)/DoD CFO needs to remove the sections of the DoD 7000.14-R that require the Navy to report shipbuilding contract financing payments in accounts other than CIP. The recommendations, if implemented, will remove the inconsistencies and noncompliant reporting requirements of the DoD 7000.14-R.

## **Recommendations, Management Comments, and Our Response**

**A.1. We recommend that Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer revise the DoD 7000.14-R, “DoD Financial Management Regulation,” to comply with the Federal accounting standards for reporting shipbuilding contract financing payments. Specifically:**

**a. Remove the sections in DoD 7000.14-R, “DoD Financial Management Regulation,” volume 4, chapter 5, “Advances and Prepayments,” October 2008 and volume 4, chapter 6, “Property, Plant and Equipment,” June 2008, which state that contract financing payments should be recorded as advances and prepayments.**

### **Management Comments**

The Acting Deputy, Chief Financial Officer disagreed with the recommendation. The Acting Deputy stated the contract financing interim payments meet the definition of advances in paragraph 57 of SFFAS No. 1. He further stated the U.S. Standard General Ledger requires that advances be reported in Account 1410, “Advances and Prepayments.” He also stated this account is prescribed for “Payments made in

contemplation of the future performance of services, receipt of goods, incurrence of expenditures, or receipt of other assets.”

The Acting Deputy stated the contract financing interim payments do not yet meet the definition of PP&E as established by SFFAS No. 6. He stated that classification of these cash disbursements as PP&E prior to acceptance of the assets would imply that the Department has acquired tangible assets as of the date of the financial statements. He also stated this presentation would mislead financial statement users as to the property owned, managed, and controlled by the Department and reduce the clarity of the financial statement information reported.

## ***Our Response***

The Acting Deputy’s comments were nonresponsive. The Acting Deputy’s statement provided criteria for presenting CIP and PP&E that are not Federal accounting standards. Additionally, the Acting Deputy’s comments did not include a proposed resolution for discussing the Navy’s potential double posting shipbuilding contract financing payments if he does not change the wording in DoD 7000.14-R, volume 4, chapter 5.

Specifically, the Acting Deputy’s statement that contract financing payments meet the SFFAS No.1 definition of advances is not accurate. SFFAS No. 1 states that advances are cash payments to cover a part or all of anticipated expenses or as advance payments for the cost of goods and services the entity acquires. As stated in the report, shipbuilding contract financing payments do not meet the SFFAS No. 1 definition of advances because the Government is providing the contract financing payments for either work performed or actual expenditures the contractor has incurred (as opposed to anticipated expenses).

Furthermore, the Acting Deputy’s statement that contract financing payments should not be recorded in CIP because acceptance has not yet occurred on the final asset is not based on Federal accounting standards. Specifically, SFFAS No. 6 states that PP&E shall be recognized when the title passes to the Government and does not mention acceptance as a requirement. The Government takes title to the work-in-process asset either when the contract is signed or the first contract financing payment is made. Therefore, the shipbuilding contract financing payments represent the work-in-process and should be recorded in the PP&E subaccount CIP.

In addition, the Acting Deputy’s statement that presenting the contract financing payments for PP&E assets in CIP would mislead financial statement users as to the property owned, managed, and controlled by the Department is lacking in support from the Federal accounting standards. Specifically, the SFFAS No. 6 definition of PP&E does not state that the entity must own, manage, and control the PP&E before it records the asset as PP&E. As previously discussed, SFFAS No. 6 states only that title shall pass to the entity in order to record it as PP&E. Therefore, users of the financial statement would not be misled and assume that all property reported on the financial statements are owned, managed, and controlled by the Department because that is not the criteria for reporting PP&E.

The Acting Deputy did not comment on the two sections of the DoD 7000.14-R that provide conflicting guidance for shipbuilding financing payments. Specifically, DoD 7000.14-R volume 4, chapter 6 states that CIP accounts are only utilized for construction of real property and shipbuilding while volume 4, chapter 5 directs that contract financing payments be reported as advances. If the Deputy does not remove the requirement that

entities report contract financing payments as advances, contract financing payments for shipbuilding could be reported in CIP and Advances.

We request that the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Office reconsider and provide additional comments in response to the final report.

**b. Remove the sections in DoD 7000.14-R, “DoD Financial Management Regulation,” volume 4, chapter 5, “Advances and Prepayments,” October 2008 and volume 4, chapter 6, “Property, Plant and Equipment,” June 2008, which state that contract financing payments are not tangible assets.**

### ***Management Comments***

The Acting Deputy, Chief Financial Officer disagreed with the recommendation. The Acting Deputy stated that SFFAS No. 6 specifically defines PP&E as “tangible assets.” He also stated that accounting literature defines “tangible” as “having physical substance.” The Acting Deputy stated that advances are payments made in anticipation of future performance by the contractor, including future delivery of tangible assets. He further stated that contract financing payments made to contractors do not have physical substance and are not tangible assets, thus these payments are not recognized as PP&E.

### ***Our Response***

The comments from the Acting Deputy were nonresponsive. We agree that SFFAS No. 6 does state that PP&E are tangible assets and we firmly believe that shipbuilding contract financing payments meet that definition. Shipbuilding contract financing payments represent expenditures for the tangible work-in-process assets completed by the contractor. Therefore, the statement that contract financing payments are not tangible assets is inaccurate.

As stated in our report, intangible assets are generally defined as noncurrent resources that do not have physical substance. Intangible assets usually have a degree of uncertainty concerning their future benefit. They include patents, copyrights, franchises, goodwill, trademarks, trade names, and secret processes. The shipbuilding assets that the contractor produces have a certain future benefit to DoD as part of the Navy fleet ships and are not intangible assets.

We request that the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer reconsider and provide additional comments in response to the final report.

**c. Remove the section in DoD 7000.14-R, “DoD Financial Management Regulation,” volume 6b, chapter 4, “Balance Sheet,” January 2006, which states that contract financing payments (excluding progress payments based on a percentage of completion) for fixed-price contracts be reported in the Other Asset account.**

### ***Management Comments***

The Acting Deputy, Chief Financial Officer disagreed with the recommendation. The Acting Deputy stated that the USSGL requires that advances be reported in USSGL Account 1410. He also stated that in the established crosswalks, Account 1410 is presented as Other Assets on the Balance Sheet. The Acting Deputy stated that Office of Management and Budget Circular A-136, “Financial Reporting Requirements,” Revised

June 3, 2008, confirms this presentation. He also stated that the DoD 7000.14-R is consistent with the Department's accounting treatment of contract financing payments.

### ***Our Response***

The comments from the Acting Deputy Chief Financial Officer were nonresponsive. As mentioned in the finding section and our audit response for Recommendation A.1.a, contract financing payments do not meet the SFFAS definition of advances.

Furthermore, the Navy did not report contract financing payments for shipbuilding as advances as directed by the DoD 7000.14-R. The Navy was expensing contract financing payments for shipbuilding as of March 31, 2008. We disagree that contract financing payments should be reported as advances. We agree with the Acting Deputy's comments that the USSGL requires that advances be reported in the USSGL Account 1410, which is subsequently crosswalked to Other Assets.

The Acting Deputy did not comment on the existence of conflicting guidance for shipbuilding financing payments. DoD 7000.14-R volume 6b, chapter 4 requires that contract financing payments be reported as Other Assets while volume 4, chapter 6 states that CIP accounts are utilized for construction of real property and shipbuilding. If the Acting Deputy does not remove the requirement that entities report contract financing payments as Other Assets, there is a potential that contract financing payments for shipbuilding will be reported in both the CIP and Other Assets accounts.

We request that the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer reconsider and provide additional comments in response to the final report.

**A.2. We recommend that the Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller), upon completion of Recommendation B, determine the financial statement effect of the misclassification of shipbuilding financing payments as expenses and consider making a prior period adjustment or other appropriate disclosure.**

### ***Management Comments***

The Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) did not provide comments on the recommendation. We request that he provide comments in response to the final report.



## **Finding B. Navy Tracking of Shipbuilding Contract Financing Payments to Compile a Construction-in-Progress Balance**

The P&EPO and the Navy methodology for compiling shipbuilding CIP did not result in complete and accurate information. Using the current methodology, the Navy:

- did not include a reconciliation of the ending balance to source transactions;
- did not include a complete list of all ships under construction;
- included complete ships that were no longer under construction; and
- did not correctly value the ships it did include.

Without improving the methodology, the P&EPO and the Navy cannot assert that the shipbuilding CIP is audit-ready and free from material misstatement. To accurately value shipbuilding assets, the P&EPO and the Navy need to implement controls to ensure that the Navy reconciles the ending CIP balance to source documentation, captures information on all ships under construction, and identifies all CIP transactions that should be included.

### **Revised Shipbuilding Guidance**

During the audit, the OUSD(C)/DoD CFO issued new guidance requiring the Navy to report shipbuilding in its CIP balance. The P&EPO had compiled these CIP balances as of March 31, 2008 but the Navy did not post the amounts to its CIP account. Prior OUSD(C)/DoD CFO guidance did not specifically address shipbuilding contract financing payments. The Navy stated that it planned to use the current shipbuilding CIP compilation process to comply with the new OUSD(C)/DoD CFO policy. Therefore, we reviewed the P&EPO methodology for compiling the March 31, 2008, balances to determine whether the P&EPO compiled an accurate and auditable shipbuilding CIP balance.

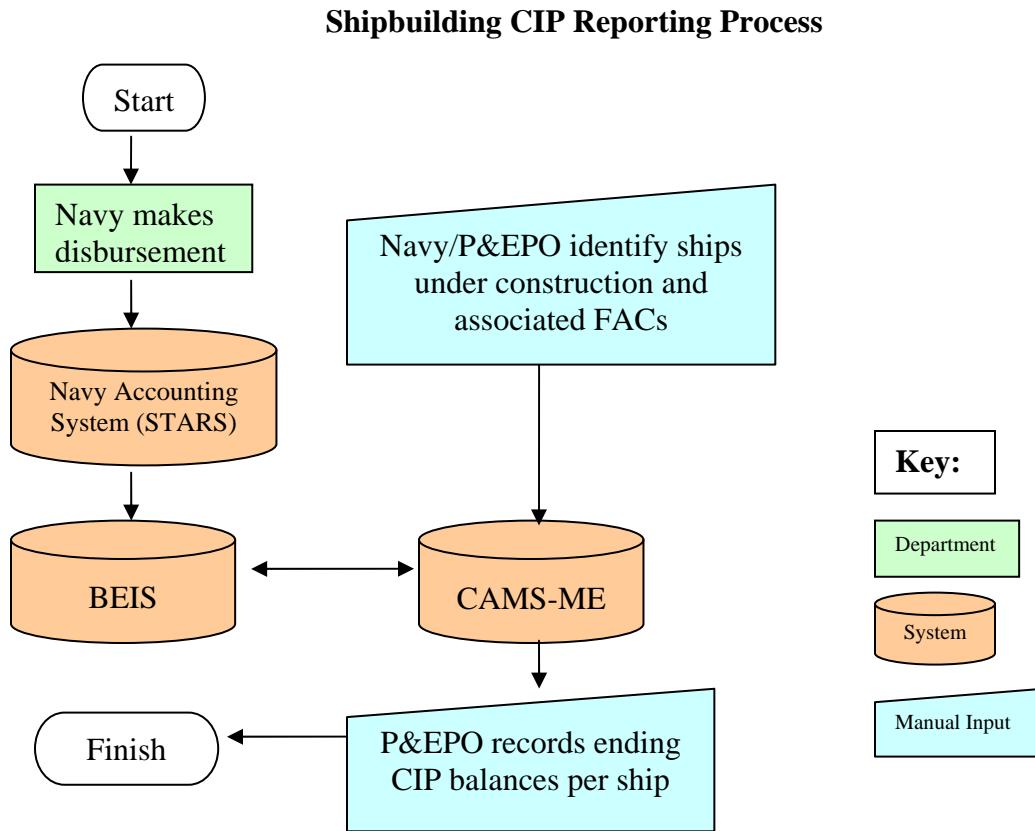
### **Shipbuilding CIP Process**

The Navy works with the P&EPO to identify the Financial Accounting Code (FAC), which enables the P&EPO to identify the CIP payments. The FAC is composed of the appropriation, beginning fiscal year of the appropriation, subhead, and project unit (also known as the Unique Identification Code).

Once the P&EPO and the Navy identified the FACs, they input them into the Capital Asset Management System-Military Equipment (CAMS-ME). CAMS-ME then interfaced with Business Enterprise Information System (BEIS) to obtain summary shipbuilding expenditure information using those FACs.\* The P&EPO used the summary expenditure data to record the ending shipbuilding CIP balances on a spreadsheet. The Navy plans to post the amounts recorded on the spreadsheet to the CIP account. See the following flow chart for a summary of the shipbuilding CIP reporting process.

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\* BEIS is populated from the Navy Financial Accounting System (Standard Accounting and Reporting System [STARS]).



## Auditability of P&EPO Shipbuilding CIP Balances

The P&EPO and the Navy's shipbuilding CIP ending balance was not auditible. The P&EPO obtained summary expenditure data and did not include any detailed records that supported the summary amounts. The P&EPO and the Navy could not provide detailed transactions that agreed with the ending balances that the P&EPO reported.

We attempted to duplicate the P&EPO results by using its methodology for obtaining the CIP balances. We used the FACs provided by the P&EPO to gather all related disbursements from the Navy's disbursement query program. We then summarized the detailed transactions by ship and compared the summary amount to the P&EPO summary CIP balances. Out of the 25 ships the P&EPO correctly identified as having CIP balances, we found differences among the reported value and our derived value, ranging from 2.8 percent to 689.3 percent. As a result, the current ending balances are not auditible. Table 2 compares the P&EPO compiled ending CIP balances to the auditor-derived balances using the same P&EPO FACs entered into CAMS-ME.

**Table 2. Comparison of P&EPO Summary Balances and Detailed Transactions**

Program	P&EPO Summary CIP Balance	Auditor-Derived Balances	Absolute Difference of P&EPO Summary and Detailed CIP Balances	Percent Difference
CVN 77	\$ 4,274,369,118	\$ 4,835,239,945	\$ 560,870,827	13.1
CVN 78	3,223,265,044	2,853,853,213	369,411,831	11.5
SSN 778	1,458,210,216	1,793,457,132	335,246,916	23.0
SSN 779	1,528,031,978	1,711,936,887	183,904,909	12.0
SSN 780	1,465,362,505	1,331,113,372	134,249,133	9.2
SSN 781	1,430,182,798	1,107,413,027	322,769,771	22.6
LPD 20	770,878,798	1,027,141,839	256,263,041	33.2
LPD 21	665,648,201	1,042,847,160	377,198,959	56.7
LPD 22	723,514,335	668,614,621	54,899,714	7.6
LPD 23	548,112,085	410,578,139	137,533,946	25.1
LPD 24	619,218,396	363,916,922	255,301,475*	41.2
AKE 5	567,284,015	303,377,271	263,906,744	46.5
AKE 6	480,121,798	257,324,120	222,797,678	46.4
AKE 7	434,021,567	228,024,021	205,997,546	47.5
AKE 8	192,866,142	105,190,976	87,675,166	45.5
DDG 103	429,759,790	591,155,530	161,395,740	37.6
DDG 105	425,581,505	474,520,283	48,938,778	11.5
DDG 106	744,664,897	1,284,570,806	539,905,909	72.5
DDG 107	7,981,793	63,003,184	55,021,391	689.3
DDG 108	52,455,250	53,899,904	1,444,654	2.8
DDG 109	561,152	2,081,614	1,520,462	271.0
DDG 111	11,806,564	22,237,991	10,431,427	88.4
LHD 8	1,319,934,936	1,774,663,429	454,728,493	34.5
LCS	1,014,888,394	716,164,449	298,723,945	29.4
<b>Total</b>	<b>\$ 22,388,721,277</b>	<b>\$ 23,022,325,833*</b>	<b>\$ 5,340,138,454</b>	

The difference between the ending CIP balances reported by the P&EPO and the auditor-derived ending CIP balance is \$634 million, but there is an absolute difference of \$5.3 billion between the ending CIP balances. The \$5.3 billion represents a material understatement of 24 percent in the ending CIP balance compiled by the P&EPO.

DoD Inspector General (IG) Report No. D-2009-008, “Internal Controls Over the Department of the Navy Military Equipment Baseline Valuation Effort,” October 31, 2008, identified that the P&EPO and the Navy did not accurately calculate program acquisition values for the Military Equipment Baseline. That audit discusses the same military equipment valuation issue that we found with the ending shipbuilding CIP balances. The Navy concurred with the audit finding and stated that it has a plan that will

\* Mathematical differences are due to rounding.

allow it to reconcile military equipment expenditures (in BEIS) with disbursements. Because the DoD IG has already identified this weakness for the Military Equipment balance and the Navy is taking corrective actions, we are not making further recommendations.

## **Accuracy of P&EPO Shipbuilding CIP Balances**

Although the Navy lacked detailed transactions to support the P&EPO ending CIP balances, we performed tests using P&EPO FACs entered in CAMS-ME to determine whether the P&EPO methodology would result in accurate ending CIP balances. Based on our analysis, the current P&EPO methodology resulted in inaccurate ending CIP balances. Specifically, the P&EPO CIP balance excluded CIP for ships currently under construction, included CIP for other ships not under construction, and inaccurately valued CIP for the remaining ships under construction.

### ***Ships under Construction and Ships Not Under Construction***

The P&EPO and the Navy methodology inaccurately identified ships under construction as of March 31, 2008. Although the P&EPO and the Navy correctly identified 25 of the 31 ships under construction, they incorrectly excluded 6 ships that were under construction and included 4 ships that were no longer under construction.

The six ships under construction that the P&EPO and the Navy excluded as of March 31, 2008, had CIP balances totaling \$2.2 billion. The NAVSEA program offices confirmed that each of these ships was under construction as of March 31, 2008. Therefore, the P&EPO needed to include disbursements for these ships in the ending CIP balance. Table 3 lists the ships that P&EPO and the Navy should have included in their ending CIP balances as of March 31, 2008.

**Table 3. Ships Excluded from the March 31, 2008, P&EPO CIP Balances**

<b>Ship Number</b>	<b>Balance of Disbursements for Ships as of March 31, 2008</b>
DDG 112	\$ 824,237,781
DDG 110	281,235,267
SSN 783	530,149,246
SSN 782	417,401,398
LPD 25	156,202,682
T-AGM	9,881
<b>Total</b>	<b>\$ 2,209,236,255</b>

In addition to the six ships improperly excluded from the March 31, 2008, ending CIP balance, the P&EPO and the Navy reported CIP balances totaling \$2 billion for four ships that should not have been included. The four ships were not under construction as of March 31, 2008. Specifically, the contractor delivered DDG 104 and ARS 52 prior to March 31, 2008, and the contractor had not begun construction on DDG 1000 and DDG 1001 as of March 31, 2008. Table 4 lists the ships that the P&EPO inaccurately included in the ending CIP balance.

**Table 4. Ships Inaccurately Included in the March 31, 2008, P&EPO CIP Balances**

Ship Number	March 31, 2008, Summary P&EPO CIP Balance
DDG 104	\$ 778,247,177
DDG 1000	568,997,377
DDG 1001	645,976,724
ARS 52	54,786,633
<b>Total</b>	<b>\$ 2,048,007,911</b>

Neither the P&EPO nor the Navy could explain why these ships were included in the ending CIP balance. The P&EPO and the Navy did not have an office responsible for consistently tracking shipbuilding. One office should be responsible for developing and implementing procedures to ensure that it tracks ships under construction and excludes ships not under construction. Until there are accurate and up-to-date records of the ships under construction, the P&EPO and the Navy will continue to misstate the ending shipbuilding CIP balances.

### **Valuation**

For the 25 ships that the P&EPO and the Navy correctly identified as having CIP balances as of March 31, 2008, the P&EPO calculated inaccurate ending CIP balances for 21 of those ships. Specifically, the P&EPO used only the FACs entered in CAMS-ME, which resulted in inaccurate Navy shipbuilding CIP balances for 21 of the 25 ships under construction as of March 31, 2008.\*

The P&EPO methodology potentially excluded \$3.9 billion of disbursements that should have been included in the CIP balance. The P&EPO and Navy excluded the \$3.9 billion because they did not enter all required FACs into CAMS-ME. Because the P&EPO and the Navy did not include all FACs, the P&EPO and the Navy potentially understated the ending balance of CIP by \$3.9 billion for the ships under construction, which is 17 percent of the \$23 billion reported as ending CIP.

Of the \$3.9 billion the P&EPO and the Navy excluded from the ending CIP balance, \$2.9 billion represented disbursements on the hull of the ship and \$1 billion was for everything else that goes on the ship. We researched \$2.2 billion of the \$2.9 billion related to the prime contracts and concluded that those amounts represented purchases for items that should have been valued in the ending CIP balances. The \$1 billion of non-prime contract disbursements had the same FACs as the excluded prime contracts disbursements. Therefore, the \$1 billion would have been included in the ending CIP balance if P&EPO and the Navy FACs had entered them into CAMS-ME. Table 5 shows the amount of excluded CIP balances per class of ship.

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\* The P&EPO methodology reported the SSN class of ships accurately. These were valued correctly.

**Table 5. Understatement of Ending CIP Balances**  
(in millions)

Class	Auditor-Derived Ending CIP Balance	P&EPO Methodology	Mis-Statement	Percent Difference
CVN 68	\$8,136.0	7,689.1	446.9	5.8%
SSN 74	5,989.0	5,943.9	45.1	0.8
LPD 17	3,990.5	3,513.1	477.4	13.6
AKE 1	968.5	893.9	74.5	8.3
DDG 51	4,683.1	2,491.5	2,191.6	88.0
LHD1	2,038.2	1,774.7	263.5	14.8
LCS 1	1,127.8	716.2	411.6	57.5
<b>Total</b>	<b>26,933.0*</b>	<b>23,022.3*</b>	<b>3,910.7*</b>	<b>17.0</b>

The P&EPO and the Navy could not provide an explanation for why the FACs were not entered into CAMS-ME. Until P&EPO and the Navy implement controls to research and identify all FACs that should be valued in the ending CIP balances, the Navy CIP balances will continue to be undervalued.

## Conclusion

Because we were not able to duplicate the P&EPO CIP account balance and the Navy was unable to provide detailed support for those balances, P&EPO and the Navy could not provide an auditable CIP balance. The Navy has stated that it has a plan that will eventually allow it to reconcile military equipment expenditures with disbursements and correct the problem. However, even if that problem is corrected and the Navy can ensure that the summary CIP ending balances are supported by detailed disbursement data, the current P&EPO methodology will still result in an inaccurate CIP ending balance because it excludes ships under construction, includes ships that are not under construction, and understates the remaining ships under construction.

These control issues are material to the March 31, 2008, CIP ending balance and will continue to result in inaccurate Navy shipbuilding CIP amounts. The P&EPO and the Navy need to implement controls to ensure that these weaknesses are corrected. The Navy needs to ensure it includes all payments that should be capitalized.

## Recommendations, Management Comments, and Our Response

**B. We recommend that the Acting Deputy Director, Acquisition Resources and Analysis for Property and Equipment Policy, in conjunction with the Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) implement controls over the shipbuilding Construction-in-Progress. Specifically, the controls should ensure that the ending balance:**

1. Includes all current ships under construction.
2. Excludes ships no longer under construction.
3. Includes all payments that should be capitalized.

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\* Mathematical differences are due to rounding.

## **Management Comments Required**

The Acting Deputy Director, Acquisition Resources and Analysis for Property and Equipment Policy and the Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) did not provide comments on the draft report. We request that they provide comments on the final report.



## **Appendix. Scope and Methodology**

We conducted this financial audit from March 2008 through January 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We reviewed the Navy's financial statements as of March 31, 2008. We performed a review of shipbuilding payments prior to March 31, 2008, to determine what account the payments were posted to on the financial statements. We reviewed the Federal accounting standards to determine where the shipbuilding contract financing payments should be posted. We also reviewed guidance provided by the OUSD(C)/DoD CFO to determine whether the guidance was in compliance with Federal accounting standards.

We obtained a list of ships under construction as of March 31, 2008, from the Naval Vessel Registry, as well as from conversations with members of program offices. We compared the list of ships reported by the P&EPO to our list of ships under construction.

We reviewed the Navy's process for entering FACs into the CAMS-ME and using those FACs to obtain records from the Navy's Cash History On-Line Operator Search Engine (CHOOSE). In order to test the accuracy of the FACs entered into CAMS-ME, we compared FACs provided by the P&EPO to the FACs used on payments taken from CHOOSE.

We tested the accuracy of the P&EPO's ending CIP balance by duplicating its process of using FACs entered into CAMS-ME to pull payment information from Navy's CHOOSE. We compared the ending CIP balance reported by the P&EPO to the ending CIP balance determined using its methodology.

We obtained payments for the ships under construction from Navy's CHOOSE to determine the possible CIP balance the P&EPO could have reported. We used payments made on the auditor's prime contract universe and added payments on non-prime contracts to determine the potential ending CIP balance. We had to remove payments on six ships that were included on our list but were not included on P&EPO's list of ships under construction.

We did not review all non-prime contracts and did not review all modifications on the prime contract to ensure that all payments made on those contracts should be included in the ending value of the ship. Because of limited testing we are uncertain that all non-prime contracts contain payments that can be capitalized and not expensed.

## **Use of Computer-Processed Data**

We relied on computer-processed data contained in CHOOSE. We assessed the reliability of the data and found that the data is sufficiently reliable to meet the audit objectives. We did not test the CAMS-ME or BEIS systems but found through testing the processes that the data were unreliable. We did not rely on data from either system. We used data from the Defense Departmental Reporting System (DDRS) for background purposes and did not rely on the data for audit results. We did not perform any testing on DDRS.

## **Prior Coverage**

During the last 5 years, the Department of Defense Inspector General (DoD IG) has issued three reports discussing contract financing and one report on the Navy Military Equipment valuation. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

### ***DoD IG***

DoD IG Report No. D-2009-008, “Internal Controls Over the Department of the Navy Military Equipment Baseline Valuation Effort,” October 31, 2008

DoD IG Report No. D-2008-042, “Reporting of Contract Financing Interim Payments on the DoD Financial Statements,” January 31, 2008

DoD IG Report No. D-2006-050, “Accuracy of Navy Contract Financing Amounts,” February 13, 2006

DoD IG Report No. D-2005-062, “Recording and Accounting for DoD Contract Financing Payments,” May 10, 2005

# Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) Comments



OFFICE OF THE UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100

FEB 09 2009

COMPTROLLER

MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE BUSINESS  
OPERATIONS, OFFICE OF INSPECTOR GENERAL,  
DEPARTMENT OF DEFENSE

SUBJECT: Comments to Draft Audit Report, "Navy Reporting of Financing Payments  
for Shipbuilding on the Financial Statements," (Project No. D2008-D000FJ-  
0177.000)

This memorandum is in response to your request for comments on the audit  
recommendations contained in the subject draft audit report issued January 9, 2009.

We do not concur with the Office of Inspector General, Department of Defense  
recommendations that the Department revise the Department of Defense Financial  
Management Regulation (DoDFMR) to require the military departments to record  
contract financing interim payments as Construction Work-in-Process. We maintain that  
the Department's accounting practices and the DoDFMR policies for contract financing  
payments are compliant with the Statements of Federal Financial Accounting Standards  
and accurately reflect the legal and financial status of the Department. However, our  
response to the report recommendations is in the Attachment.

Although the draft report addresses a remaining long-term unresolved issue, we  
appreciate the opportunity to provide the Department's position on this unresolved  
issue by responding to your audit recommendations. My point of contact is  
Ms. Debra J. Carey. She can be reached by telephone at (703) 602-0155 or email at  
debra.carey@osd.mil.

David P. Smith  
Acting Deputy Chief Financial Officer

Attachment:  
As stated

**DOD OIG DRAFT REPORT DATED JANUARY 7, 2009**  
**PROJECT NO. D2008-D000FJ-0177.000**  
**“NAVY REPORTING OF FINANCING PAYMENTS FOR SHIPBUILDING**  
**ON THE FINANCIAL STATEMENTS”**  
**OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)**  
**(OUSD(C)) RESPONSE TO THE DOD OIG RECOMMENDATIONS**

**RECOMMENDATION A.1.a:** Recommend that Office of the Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer (OUSD(C)) remove the sections in DoD 7000.14-R, “DoD Financial Management Regulation,” volume 4, chapter 5, “Advances and Prepayments,” October 2008 and volume 4, chapter 6, “Property, Plant and Equipment,” June 2008, which state that contract financing payments should be recorded as advances and prepayments.

**OUSD(C) RESPONSE:** The Department nonconcurs with the OIG recommendation. Contract financing interim payments are cash disbursements made to a contractor to finance the performance under the contract prior to acceptance of goods or services. These payments meet the definition of Advances in paragraph 57 of SFFAS No. 1, *Accounting for Selected Assets and Liabilities*. Further, U.S. Standard General Ledger (USSGL) published and maintained by the Financial Management Service of the U.S. Department of the Treasury requires that Advances be reported in USSGL Account 1410, *Advances and Prepayments*. This account is prescribed for “Payments made in contemplation of the future performance of services, receipt of goods, incurrence of expenditures, or receipt of other assets.”

The Department does not recognize contract financing interim payments as Construction Work-in-Process because these payments do not yet meet the definition of Property, Plant and Equipment (PP&E) established by Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant and Equipment*. SFFAS No. 6 defines PP&E as tangible assets that have an estimated useful life of two years or more; are not intended for sale in the ordinary course of operations; and are intended to be used or available for use by the entity. Classification of these cash disbursements as PP&E prior to acceptance of the assets would imply that the Department has acquired tangible assets as of the date of the financial statements. This presentation would mislead financial statement users as to the property owned, managed, and controlled by the Department and reduce the clarity of the financial statement information reported.

**RECOMMENDATION A.1.b:** Recommend that the OUSD(C) remove the sections in DoD 7000.14-R, “DoD Financial Management Regulation,” volume 4, chapter 5, “Advances and Prepayments,” October 2008 and volume 4, chapter 6, “Property, Plant and Equipment,” June 2008, which state that contract financing payments are not tangible assets.

**OUSD(C) RESPONSE:** The Department nonconcurs with the OIG recommendation. SFFAS No. 6 specifically defines Property, Plant, and Equipment as “tangible assets.” Accounting literature also defines “tangible” as “having physical substance.” Advances are payments made in anticipation of future performance by the contractor, including future delivery of tangible assets. However, contract financing payments made to contractors do not have physical

Attachment  
Page 1 of 2

substance and are not tangible assets, thus these payments are not recognized as Property, Plant, and Equipment. Hence, contract financing payments are not tangible assets.

**RECOMMENDATION A.1.c:** Recommend that the OUSD(C) remove the section in DoD 7000.14-R, "DoD Financial Management Regulation," volume 6b, chapter 4, "Balance Sheet," January 2006, which states that contract financing payments (excluding progress payments based on a percentage of completion) for fixed-price contracts be reported in the Other Asset account.

**OUSD(C) RESPONSE:** The Department nonconcurs with the OIG recommendation. The USSGL requires that Advances be reported in USSGL Account 1410. In crosswalks established by the USSGL, Account 1410 is presented as Other Assets on the Balance Sheet. The Office of Management and Budget Circular A-136, *Financial Reporting Requirements*, Revised June 3, 2008 confirms this presentation. The DoDFMR is consistent with Department's accounting treatment of contract financing payments.

Attachment  
Page 2 of 2







# Inspector General Department *of* Defense

